United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

Signed

76-4062

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

POIRIER & MCLANE CORPORATION,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

B

P/S

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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Appellant

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BRIEF FOR THE APPELLANT

STATEMENT OF THE ISSUES PRESENTED

Section 461(f) of the Internal Revenue Code of 1954 allows a deduction for amounts transferred into trust to satisfy contested liabilities of the taxpayer. Here, taxpayer entered into an agreement with a trustee under which taxpayer transferred $1,100,000 for the purpose of satisfying certain contested claims against it. The claimants were unaware of the agreement. The issues presented are:

(1) Whether the Treasury Regulations under Section 461(f) of the Internal Revenue Code of 1954 require that each claimant be a party to such a trust agreement, and, if so, whether the requirement is a reasonable and, therefore, valid interpretation of the statute.

(2) Whether the funds were transferred "beyond the control" of taxpayer, as is required by the applicable Treasury Regulations in accordance with the legislative intent.

STATEMENT OF THE CASE

This is an appeal by the Commissioner of Internal Revenue from a decision of the United States Tax Court, entered on September 9, 1975. (R. 20, 70.)[1/] The decision determined a deficiency of $74,485 in income tax due from Poirier & McLane Corporation (taxpayer) for the year 1964 out of a total deficiency of $624,485.37 determined by the Commissioner. (R. 8, 70.)[2/] The reviewed opinion of the Tax Court (Judge Featherston) was filed on March 10, 1975 (R. 2, 37) and is reported at 63 T.C. 570. The Commissioner timely filed a notice of appeal on December 5, 1975. (R. 2.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

The material facts, as found by the Tax Court and as otherwise reflected on the record, may be summarized as follows:

Taxpayer is a corporation engaged during 1964, the taxable year at issue, in the construction of highways, viaducts and tunnels. In January, 1956, taxpayer entered into a contract with the New York City Transit Authority to reconstruct a subway tunnel and to enlarge a subway station in New York City. Under the contract, taxpayer was obligated to hold the Transit Authority harmless from all damage claims

1/ "R." references are to the separately bound record appendix. "Tr." references are to the transcript of the hearing before the Tax Court on February 21, 1974.

2/ The $74,485 deficiency was determined as a result of adjustments to taxpayer's taxable income that were made by the Commissioner and agreed to by taxpayer. (R. 11-13, 24.) None of these adjustments, accordingly, is at issue on this appeal.

resulting from the work to be performed. As a result of taxpayer's performance of the work under the contract, tenants of various properties at the construction site brought actions alleging trespass and negligence on taxpayer's part and seeking damages totalling $581,150. (R. 39-40.)

In October, 1958, taxpayer entered into a contract with the State of New York as general contractor for the construction of a parkway in Yonkers, New York. Like taxpayer's contract with the New York Transit Authority, this contract required taxpayer to hold the State of New York harmless from all damage claims resulting from the work performed under the contract. In 1960, as a result of work performed under this contract, Bronxville-Palmer, Ltd., the owner of an apartment building adjacent to the site for the parkway, brought actions against taxpayer and the State of New York, among other defendants, seeking damages aggregating $14,200,000 for alleged trespass and negligence. (R. 40-41.)

On December 31, 1964, as a result of advice by taxpayer's counsel, insurance broker and accountant urging the creation of reserves to satisfy any judgments or portions thereof for which taxpayer would be uninsured, taxpayer entered into a trust agreement with Manufacturers Hanover Trust Company. Under the agreement, taxpayer transferred $1,100,000 in a certificate of deposit and Treasury bills to Manufacturers Hanover Trust Company, as trustee. The agreement, to which none of the persons asserting claims against taxpayer was a party, provided, _inter alia_, that the $1,100,000 fund was to be held by the trustee for the sole purpose of paying taxpayer's obligations that might arise from the litigation against taxpayer, and that the balance of the fund remaining after the disposition of

the claims against taxpayer would be returned to taxpayer upon its statement that the claims had been determined and disposed of. (R. 25-29, 41, 42, 43, 44.)

On September 8, 1969, the New York State Court of Claims awarded Bronxville-Palmer, Ltd., the claimant in the parkway contract litigation, damages of $11,600 plus interest on one of its two claims alleging negligence on the part of the State of New York in the construction of the parkway. Although taxpayer was required by its construction contract to indemnify the State for these damages, the amount awarded by the Court of Claims apparently did not exceed the maximum insurance coverage taxpayer had for negligence.[3/] (R. 44-45. See Bronxville Palmer, Ltd. v. State of New York, 25 App. Div. 2d 709, 268 N.Y.S. 2d 727 (3d Dep't, 1966), aff'd, 18 N.Y. 2d 560, 223 N.E. 2d 887 (1966); Bronxville Palmer, Ltd. v. State of New York, 34 App. Div. 2d 714, 309 N.Y.S. 2d 672, 673 (3d Dep't, 1970), rescinded, 36 App. Div. 2d 10, 318 N.Y.S. 2d 57 (3d Dep't, 1971), modified 30 N.Y. 2d 760, 284 N.E. 2d 577 (1972).)

The following month, taxpayer notified the trustee of the $1,100,000 fund that all claims referred to in the trust agreement had been disposed of and requested the return of the fund. Pursuant to this request, the trustee returned the entire principal of the fund, plus interest and less trust fees, to the taxpayer in November, 1969. (R. 45-46.)

3/ At a hearing before the Tax Court on February 21, 1974, taxpayer's counsel stated that taxpayer's insurance coverage against negligence was limited to $500,000. (Tr. 4.)

That same month, the State Court of Claims entered an order suspending the accrual of interest on the damages awarded for a period of approximately two years and eight months. See Bronxville Palmer, Ltd. v. State of New York, 34 App. Div. 2d, p. 714, 309 N.Y.S. 2d, p.673. Five months later, in April, 1970, the Appellate Division of the New York State Supreme Court reversed the Court of Claims' order suspending the accrual of interest on the award. Bronxville Palmer, Ltd. v. State of New York, supra, 34 App. Div. 2d 714, 309 N.Y.S. 2d 672.

In February, 1971, the Appellate Division also modified the award itself by increasing the damages awarded to $14,200. Bronxville Palmer v. State of N.Y., 36 App. Div. 2d 10, 318 N.Y.S. 2d 57 (3d Dep't, 1971), modified, 30 N.Y. 2d 760, 284 N.E. 2d 577 (1972). At the same time, the Appellate Division reversed a judgment of the State Court of Claims that had dismissed for lack of jurisdiction Bronxville-Palmer, Ltd.'s second claim for damages on account of the State's alleged negligence. Bronxville Palmer, Ltd. v. State of New York, 36 App. Div. 2d 647, 318 N.Y.S. 2d 412 (3d Dep't, 1971).

While the subsequent history of the second claim is not revealed by the record, the first claim was finally determined by the New York State Court of Appeals in May, 1972. In that decision, the Court of Appeals upheld the Appellate Division's ruling increasing the damages to $14,200, but deleted the provision of the Appellate Division's order denying the suspension of interest on the award. Bronxville Palmer, Ltd. v. State of New York, 30 N.Y. 2d 760, 284 N.E. 2d 577.

On its income tax return for 1964, taxpayer took a deduction for the $1,100,000 fund transferred to the trustee under the trust agreement. (R. 44.) In his notice of deficiency, the Commissioner disallowed the deduction on the ground that taxpayer had failed to establish that the amount of the trust fund was properly deductible under the accrual method of accounting, which taxpayer used. (R. 12, 46.) Taxpayer filed a petition for a redetermination of the resulting deficiency with the Tax Court (R. 3-7), which held that the $1,100,000 fund qualified for deduction under Section 461(f) as property transferred to provide for the satisfaction of contested liabilities. From the decision entered in accordance with this holding of the Tax Court, this appeal is taken.

SUMMARY OF ARGUMENT

Taxpayer, in 1964, transferred $1,100,000 into trust, purportedly to satisfy contested damage claims against it, but without the knowledge of the claimants. The Tax Court upheld taxpayer's claim to a deduction for the amount transferred under Section 461(f) of the Internal Revenue Code of 1954.

Section 461(f) was enacted to permit deduction of contested liabilities by an accrual basis taxpayer, in the amount of money or other property which is transferred to satisfy the liabilities. To qualify, however, such a transfer, if into trust, must place the trust fund "beyond the control" of the taxpayer. S. Rep. No. 830, Part 2, 88th Cong., 2d Sess., p. 243 (1964-1 Cum. Bull. (Part 2) 700, 746). To implement this requirement, Treasury Regulations on Income Tax provide that such a transfer, in order to qualify under

Section 461(f), must be pursuant to a written agreement "among * * * the trustee, the taxpayer, and the person who is asserting the * * * [claim]".) Treasury Regulations on Income Tax (1954 Code), Sec. 1.461-2(c).

Because taxpayer here transferred the funds into a secret trust (i.e., without the knowledge of the claimants), it is not entitled to a deduction for either of two reasons. First, the requirement of the regulation--that the claimant or claimants be party to the trust agreement--is not only reasonable, but is essential to insure that the funds are in fact "beyond the control" of the taxpayer. Second, under the facts of this case, taxpayer (and not the claimants) was the beneficiary of the trust and, therefore, could revoke it at will at any time; accordingly, the trust funds were not at any point beyond taxpayer's control.

1. Under settled principles of trust law, a trust for payment of creditors, created without the creditor's express agreement, is inferred to be for the benefit of the grantor and not of the creditors. While the inference is rebuttable, there would not appear to be any cases holding such a creditor to be the beneficiary where, as here, his claim is contested by the grantor. In any event, the Regulation's requirement of agreement by the claimant is a reasonable interpretation of the statute because, in the interest of efficient tax law administration, it does no more than establish as a rule of tax law a result which would almost certainly prevail under general legal principles. Moreover, if the holding below were allowed to stand, it would convert Section 461(f) into a convenient device for substantial tax avoidance. The secret trust is an arrangement which

would have no reason or purpose absent tax motivation. But under the holding below, it would become a tool for manufacturing a deduction, of flexible amount and timing, while shielding the taxpayer from any possible adverse effects on its litigation posture vis-a-vis the third-party claimants. There is no indication that Congress intended any such result. Rather, Congress had before it only arrangements known to both the taxpayer and the claimant.

2. The result below is wrong, in any event, because under applicable trust law the transfer here did not place the funds beyond taxpayer's control. This is because taxpayer was the sole beneficiary of the trust, and therefore was at all times in a position to revoke the trust. Cases which have held creditors to be beneficiaries under similar trusts are both few in number and distinguishable on their facts. Generally, in each instance, they involve a transfer by a debtor for the purpose of discharging specific matured debts in specific amounts. Here, by contrast, the trust was established to pay liabilities of uncertain amounts; it in fact was never called on to pay any portion of the liabilities in question; and the entire arrangement was kept secret throughout from the potential payees. Under these circumstances, as a matter of law, taxpayer should not be heard to contend that the trust was not created for its own benefit, but for that of payees (a) who were kept in the dark as to its existence, (b) the payment of whose claims were not enhanced in any regard by the trust, and (c) who in fact never received any benefit or payment from the trust.

The decision of the Tax Court is wrong and should be reversed.

ARGUMENT

TAXPAYER IS NOT ENTITLED TO A DEDUCTION UNDER SECTION 461(f) BECAUSE IT DID NOT TRANSFER THE FUNDS BEYOND ITS CONTROL

A. Introduction

The sole issue in this appeal is whether taxpayer is entitled to a deduction under Section 461(f) of the Internal Revenue Code of 1954, Appendix, infra, for the $1,100,000 which it transferred into trust in 1964. The answer hinges, in turn, upon whether the transfer placed the funds "beyond the control" of taxpayer, as required by Treasury Regulations[4/] in accordance with the legislative history of the statute.[5/]

The Government's position is that the deduction is impermissible for either of two reasons: (1) the transfer violated a reasonable, and therefore valid requirement of the Treasury Regulations that the potential creditors be a party to the trust agreement, and (2) under New York trust law, in any event, the trust in this instance was revocable at will by taxpayer (and thus not beyond its control) at all times subsequent to the transfer.

Section 461(f) provides in pertinent part that if a taxpayer transfers money or other property to provide for the satisfaction of a contested liability, a deduction shall be allowable in the year of the transfer. In so providing, the statute overturned the effect of United States v. Consolidated Edison Co. of New York, 366 U.S. 380 (1961). That case held that the proper year for

4/ Treasury Regulations on Income Tax (1954 Code), §1.461-2(c), Appendix, infra.

5/ S. Rep. No. 830, Part 2, 88th Cong., 2d Sess., p. 243 (1964-1 Cum. Bull. (Part 2) 700, 746).

accruing a deduction of a contested property tax was the year in which the contest was terminated rather than the year in which the taxpayer paid the tax under protest.

The legislative history of the statute indicates an express intention on the part of Congress that, to qualify for the deduction, a transfer must place the funds "beyond the control" of the taxpayer. S. Rep. No. 830, Part 2, 88th Cong., 2d Sess., p. 243 (1964-1 Cum. Bull. (Part 2) 700, 746. In accordance with this intent, the Treasury Regulations provide that, "In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property." Regulations on Income Tax, §1.461-2(c), Appendix, infra. More specifically, the regulation requires that, where a transfer is into trust, it must be pursuant to "a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability)."

In this case, taxpayer transferred the funds into a secret trust--i.e., without the knowledge (much less the written agreement) of its potential creditors. Thus, the transfer would not seem to meet the requirement of the Regulations, and the claimed deduction is impermissible if that apparent requirement represents a reasonable interpretaion of the statute. Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948). We will demonstrate in Part B, infra, that the requirement is not only reasonable but necessary to carry out the purpose of the statute. We will further demonstrate, in Part C, infra, that under settled principles of trust law, a secret trust for the payment of contested liabilities is revocable at the will

of the grantor; this is so because, as a matter of law, the grantor and not any potential creditor is the beneficiary of the trust under such circumstances. Accordingly, the transfer here did not place the funds in question "beyond the control" of the taxpayer, whether it be viewed as a matter of pure tax law under the applicable Treasury regulation, or as a matter of local trust law which controls the tax treatment.

B. The claimants were not parties to the trust agreement, as is reasonably required by the applicable regulation

As noted, the trust in this case was a secret trust. That is, it was executed without the knowledge of the parties whose contested claims agaqnst taxpayer were potentially to be satisfied in whole or in part from the trust funds. In fact, the claims were paid, apparently in full, by taxpayer's liability insurer, and the trust fund was returned to taxpayer presumably without the claimants ever having known of its existence.

The transfer is in apparent conflict with Section 1.461-2(c) of the Regulations, *supra*, which requires that a qualifying transfer be made pursuant to a written agreement among the trustee, taxpayer and the claimant. In holding for the taxpayer, the Tax Court majority rejected the plain and usual meaning of the words of the regulation and held that an agreement "among" the three parties could somehow be satisfied by an agreement *between* only two of the three. A concurring opinion, representing the views of five judges, declared that the requirement "should be declared invalid if it is read as requiring the claimant-beneficiary to sign the written agreement." (R. 63.) A dissent, representing the views of four

judges, read the regulation as requiring the express agreement of all three parties and would have upheld the requirement's validity as so interpreted.

We submit that the majority's reading of the regulation defies basic canons of common usage of the English language. Under such usage, an agreement can be struck "between" two parties and "among" three or more parties. It cannot be struck "among" two parties, as the Tax Court in effect held.[6/] And certainly, if the Commissioner had intended to qualify a secret trust arrangement, the regulation would have had no occasion even to mention the claimant, much less to require a written agreement "among" three parties of which the claimant is one.

We submit further that, contrary to the position of the concurrence, the plain requirement of the Regulations is not only reasonable, but perhaps even a compelled interpretation of the statute. This is so for two reasons. First, settled principles of trust law recognize that, in the absence of the claimant's express agreement, such a trust ordinarily is freely revocable, and its corpus therefore is not "beyond the control" of the taxpayer. Thus, where a trust is established for the payment of creditors, but as here without the express agreement of the creditors, "the inference is that the trust is for the debtor and not the creditor, and the debtor can revoke the trust at any time without the consent of the creditor." 2 Restatement of Trusts 2d, Sec. 330, Comment h.

6/ As the dissent noted below (R. 66): "by no legitimate stretch of syntactical interpretation could there be an agreement <u>among</u> three parties which was unknown to one of the three." (Emphasis in original.)

Second, the legislative history indicates that Congress could not have intended the result below, which the dissent aptly described (R. 69) as an "avenue to facile avoidance."

1. Parties who benefit incidentally from the provisions of a trust do not, of course, thereby become beneficiaries. 2 Scott on Trusts (3d ed.), Sec. 126. Hence, the inference that the grantor is the beneficiary of a trust established for payment of creditors, in the absence of agreement of the creditors, is likewise beyond question. 2 Restatement, supra, Sec. 330, Comment h; 4 Scott, supra, Sec. 330.6; Ehag Eisen. Holding AG. v. Banca Nat. a Romaniei, 306 N.Y. 242, 251-252, 117 N.E. 2d 346, 351 (1954). And it is equally well settled that, where the grantor is the sole beneficiary, neither a failure to reserve the right to revoke, nor even a provision in the agreement that the trust shall be irrevocable, will destroy his right of revocation. Berlenbach v. Chemical Bank & Trust Co., 235 App. Div. 170, 256 N.Y.S. 563 (1st Dep't, 1932), motion for leave to appeal denied, 235 App. Div. 791, 256 N.Y.S. 946 (1st Dep't, 1932), aff'd, 260 N.Y. 539, 184 N.E. 83 (1932). It follows that, when the regulation requires the express agreement of the claimant, it does no more than insure that the trust fund has, in fact, been transferred beyond the control of the taxpayer.

It is true that the inference created by trust law--namely, that the grantor is the beneficiary of such a trust--can be rebutted by evidence that the grantor intended the creditors to be the beneficiaries. See, e.g., Cleveland Trust Co. v. Pomeroy, 16 Ohio Op. 131, 177 N.E. 2d 410 (C.P. Ct. 1961). However, research has not disclosed any case holding such a creditor to be the beneficiary

where, as here, his claim was contested by the grantor. Thus, if the regulation has the effect of treating an inference of trust law as an absolute rule for tax purposes, it does so under circumstances in which the inference would almost certainly prevail in any event.

The regulation provides, in effect, that where a trust is created to pay obligations that may not arise, and to obligees who are not informed of the trust's existence, a taxpayer-grantor will not be allowed to deny that he intended thereby primarily to benefit himself (by discharging his obligations, if any) and only incidentally to benefit the creditors whose claims might (and might not) thereby be discharged. Plainly, the rule is not only consonant with trust law, but is, in addition, in the interest of efficient tax law administration. For administration of Section 461(f) would be severely and needlessly complicated if a taxpayer were free to argue in every case, contrary to the normal inference, that he intended his creditors to be the beneficiaries.

2. The concurring Tax Court judges felt that the regulation is invalid if, as we contend, it requires the agreement of the third-party claimants. They reasoned that requiring a taxpayer to disclose the trust fund to the claimant would unreasonably force him into an undesirable and unnatural litigating position, namely, that of "admitting and defining his adversary's strength during negotiations with him, thus limiting taxpayer's field for maneuver." (R. 63.) This view would, however, permit concern for a taxpayer's litigating posture, vis-a-vis a third party, to create a glaring tax avoidance device.

The avoidance potential is clear. As pointed out by the dissent below (R. 68): "Deductions will now be subject to being manufactured and timed to please, by the simple expedient of setting aside in secret trusts the amount sought to be deducted, as long as that doesn't exceed the maximum allowable litigation exposure." A taxpayer would have nothing to lose, and a substantial tax break to gain, by setting up such a secret trust. If the litigation is lost, he would have to pay anyway. If the litigation is won, the funds are returned. Meanwhile (to quote again from the dissent below), "the secret trustor can enjoy the income, and the litigation opponent is none the wiser." (_Ibid_.)

There is nothing in the legislative history to indicate any such intent on the part of Congress. Congress sought only "to realistically and practically match receipts and disbursements attributable to specific taxable years." S. Rep. No. 830, 88th Cong., 2d Sess., p. 100 (1964-1 Cum. Bull. (Part 2) 505, 604). And it had before it only arrangements known to both the taxpayer and the potential payee, such as in the _Consolidated Edison_ case itself. The secret trust, such as used here, could not have been intended to be protected by Congress; it is a device designed in response to the legislation, and not vice versa. As pointed out by the dissent (R. 68):

> It is a rare sport, not to be found in nature. It is simply an effort to enjoy the deduction without the effects on one's litigation posture of disclosure.

Moreover, the legislative history of Section 461(f) indicates that Congress intended to allow a deduction in the year of transfer

for money or other property transferred by a taxpayer to satisfy a contested liability only so long as the transfer was made to the claimant or to an escrow agent. S. Rep. No. 830, Part 2, supra, p. 243 (1964-1 Cum. Bull. (Part 2), p. 746). The term "escrow agent" suggests a third-party depositary who acts pursuant to instructions agreed upon by the other two parties, rather than instructions issued by the depositor alone. See Home Insurance Co. of N.Y. v. Wilson, 210 Ky. 237, 241-242, 275 S.W. 691, 693 (1925); Horowitz, Creating a Trust to "Pay" Contested Liabilities Has Tax Planning Potential, 44 Journal of Taxation, No. 1, pp. 14, 15 (1976). Accordingly, the requirement of the regulation that the claimant be a party to any agreement providing for the transfer of funds to satisfy the taxpayer's potential liability for the claim also serves to implement Congress' concern that the transfer, if not made directly to the claimant, be made to an escrow agent.

Another consideration that may well have prompted the Treasury Regulation's requirement that the claimant be a party to the agreement providing for the transfer of funds is that the escrowee or trustee and the taxpayer would not have as vigorous an interest as the claimant in enforcing the requirement that the transferred funds remain beyond the taxpayer's control. Accordingly, even if a taxpayer should have no legal right to control the disposition of funds transferred under an agreeemnt between him and an escrowee or trustee, the requirement that the claimant be a third party to that agreement constitutes the best assurance that this limitation will be observed in practice.

We submit, therefore, that the requirement of the regulation is necessary both to carry out the purpose of the statute and to avoid its use as a tool of avoidance. Moreover, if there be any doubts as to its reasonableness, which we deny, such doubts should, in any event, be resolved in favor of the validity of the regulation. Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).

C. Under applicable trust law, taxpayer here, in any event, held an unqualified power to revoke the trust at any time

We have seen that taxpayer failed to qualify for the claimed deduction because the transfer into trust did not meet the "written agreement" requirement of Regulations, Sec. 1.461-2(c). The claim must fall, in any event, because under applicable trust law the transfer did not place the funds beyond taxpayer's control. Rather, taxpayer at all times was in a position to revoke the trust.

As noted above, where a grantor creates a trust for payment of a creditor, and the creditor is not a party to the arrangement, the inference is that the grantor and not the creditor is the beneficiary. 2 Restatement, supra, Sec. 330, Comment h; 4 Scott, supra, Sec. 330.6; Ehag Eisen. Holding AG. v. Banca Nat. a Romaniei, supra. As such, the grantor beneficiary can revoke the trust at will at any time. See Berlenbach v. Chemical Bank & Trust Co., supra; N.Y. Estates, Powers & Trusts Law, §7-1.9 (McKinney Supp. 1975).

An inference is, of course, generally rebuttable. Thus, creditors not party to the trust agreement have been held to be beneficiaries. But this has occurred only under circumstances sharply distinguishable from those here. In general, such cases

involve in each instance a transfer by a debtor for the purpose of discharging specific debts in specific amounts. See, e.g., Cleveland Trust Co. v. Pomeroy, 16 Ohio Op. 2d , pp. 134, 135; 177 N. . 2d, pp. 414, 415, where the creditors were relatives of the grantor, the amounts of the debts were fixed and certain, and the creation of the trust was not kept secret from the creditors. Other cases involve the transfer of the precise amount necessary to pay a single creditor. See Estate of Hovland, 38 Cal. App. 2d 439, 101 P. 2d 500 (Dist. Ct. App., 1940), Sayer v. Wynkoop, 248 N.Y. 54, 161 N.E. 417 (1928).

Here, by contrast, the trust was established to pay liabilities of uncertain amounts; it in fact was never called on to pay any portion of the liabilities in question; and the entire arrangement was kept secret throughout from the potential payees. Such a transfer lacks an element of finality--the dedication of a specific amount to payment of a specific payee--that is inherent in the cases holding creditors to be beneficiaries. Moreover, in this regard, it is significant that even where specific amounts and payees were involved, some cases have nevertheless required an express agreement on the part of the creditor. For example, the Pennsylvania Supreme Court recently held that, in order for a creditor to establish that the defendant was holding money in trust for him, he would have to show that there was an agreement with the defendant or with the debtor under which the creditor agreed to look only to that account for satisfaction of the debtor's liability. L.C.S. Colliery, Inc. v. Mack, 447 Pa. 276, 290 A. 2d 260 (1972). See also Title Guarantee & Trust Co. v. Haven, 214 N.Y. 468, 108 N.E. 819 (1915), discussed at 2 Scott, supra, Sec. 126.1.

In short, the trust in this case was, as a matter of law, intended to benefit taxpayer by discharging its liabilities if and to the extent that they might arise. By contending that it intended to benefit the third-party claimants, taxpayer ignores the jural principle that a party must necessarily intend the invevitable consequences of his acts. Here, the consequence of the trust was primarily to benefit taxpayer itself by discharging its potential liabilities. Taxpayer's contention that it intended to benefit the claimants simply does not jell, for it assumes that taxpayer intended primarily to benefit claimants whom it was unwilling to inform of the existence of the trust, who might or might not turn out to have any valid claims against taxpayer, and whose claims (even if ultimately determined to be valid) might or might not (and in fact did not) have to be satisfied by the trust funds in question. We submit that such an argument falls of its own weight, and that taxpayer, as the beneficiary of the trust, held at all times a power to revoke. The funds, accordingly, never were transferred "beyond the control" of taxpayer.

That the transferred funds were not placed beyond taxpayer's control is also clear for yet another reason, which is demonstrated by the chronology of events. On September 8, 1969, the New York State Court of Claims awarded Bronxville-Palmer, Ltd., one of the claimants herein, damages of $11,600 plus interest on one of its two claims alleging negligence on the part of the State of New York in the construction of a parkway in Yonkers, New York. Although taxpayer was required by its highway construction contract to hold the State harmless from all damage claims resulting from work

performed under the contract, the amount awarded by the Court of Claims did not exceed the maximum insurance coverage taxpayer had against negligence. (R. 40, 44-45. See <u>Bronxville Palmer, Ltd</u>. v. <u>State of New York</u>, 25 App. Div. 2d, p. 709, 268 N.Y.S. 2d, p. 727; <u>Bronxville Palmer, Ltd</u>. v. <u>State of New York</u>, <u>supra</u>, 34 App. Div. 2d, p. 714, 309 N.Y.S. 2d, p. 673.)

In October, 1969, taxpayer notified the trustee of the $1,100,000 trust fund that all claims referred to in the trust agreement had been disposed of and requested the return of the fund. Pursuant to this request, the trustee returned the entire principal of the fund, plus interest and less trustee fees, to the taxpayer in November, 1969. (R. 45-46.)

That same month the Court of Claims entered an order suspending the accrual of interest on the damages awarded for a period of approximately two years and eight months. See <u>Bronxville Palmer, Ltd</u>. v. <u>State of New York</u>, 34 App. Div. 2d, p. 714, 309 N.Y.S. 2d, p. 673. Five months later, in April, 1970, the Appellate Division of the New York State Supreme Court reversed the Court of Claims' order suspending the accrual of interest on the award. <u>Bronxville Palmer, Ltd</u>. v. <u>State of New York</u>, <u>supra</u>, 34 App. Div. 714, 309 N.Y.S. 2d 672.

In February, 1971, the Appellate Division also modified the award itself by increasing the damages awarded to $14,200. <u>Bronxville Palmer</u> v. <u>State of N.Y.</u>, <u>supra</u>, 36 App. Div. 2d 10, 318 N.Y.S. 2d 57. At the same time, the Appellate Division reversed a judgment of the Court of Claims that had dismissed for lack of

jurisdiction a second claim filed by Bronxville for damages on account of the State's alleged negligence. Bronxville Palmer, Ltd. v. State of New York, supra, 36 App. Div. 2d 647, 318 N.Y.S. 2d 412.

While the subsequent history of the second claim is not revealed by the record, and while the Appellate Division's denial of the suspension of interest on the award on the first claim was reversed in 1972 by the New York State Court of Appeals (Bronxville Palmer, Ltd. v. State of New York, supra, 30 N.Y. 2d 760, 284 N.E. 2d 577), it is clear that in November, 1969, when the $1,100,000 trust fund was returned to taxpayer, the two damage claims for negligence had hardly been disposed of. To be sure, taxpayer's management may have believed at the time that the amount of the award ($11,600 plus interest) against the State on the first claim, together with any possible increase in the award on appeal and the amount of any judgment that might eventually be entered against the State if the dismissal of the second claim should be reversed on appeal, would be well within taxpayer's maximum insurance coverage against negligence. However, as the amount and validity of the damage claims had not been finally determined at the time, presumably the $1,100,000 was returned to taxpayer before the insurance company paid the claims. Under these circumstances, taxpayer did not satisfy the requirement of the Treasury regulation that the transferred property be placed beyond the taxpayer's control.[7/]

7/ For the same reasons, taxpayer also failed to meet the concomitant requirement of Section 1.461-2(c) of the Treasury Regulations that the agreement of transfer provide that the property transferred be delivered in accordance with the settlement of the contest between the taxpayer and the claimant.

CONCLUSION

For the reasons stated, the decision of the Tax Court should be reversed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 3rd day of May, 1976, in an envelope, with postage prepaid, properly addressed to them as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

* * *

(f) [as added by Sec. 223(a)(1), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19] Contested Liabilities.--If--

(1) the taxpayer contests an asserted liability,

(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(3) the contest with respect to the asserted liability exists after the time of the transfer, and

(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

then the deduction shall be allowed for the taxable year of the transfer. This subsection shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.461-2 Timing of deductions in certain cases where asserted liabilities are contested.

* * *

(c) Transfer to provide for the satisfaction of an asserted liability--(1) In general. A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or

instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. Purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, and a transfer to an account which is within the control of the taxpayer are not transfers to provide for the satisfaction of an asserted liability. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.